Overseas law

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THE PARADOXES OF DODD-FRANK

INTRODUCTION

Like the cadmium rings of America’s great sequoia trees, the major amendments to the US securities laws mark the financial crises that have befallen the US and world economies. The most recent Great Recession, flowing from the multiple excesses in global financial markets, and particularly those in the US, produced the most sweeping change in the US financial regulatory scheme since the Great Depression.

The Dodd-Frank Wall Street Reforms and Consumer Protection Act, enacted in July 2010, provides a collage of provisions, most of which are directed to banking and derivative regulation. This note’s focus is on important corporate and securities provisions that are nested into the Act that are at best paradoxical and in some instances inconsistent with the forces that propelled Dodd-Frank onto the international scene.

REGULATORY DISPENSATIONS FOR SMALL FIRMS

Small public companies scored a number of victories with the enactment of Dodd-Frank. The most notable victory is their exemption from the now infamous s 404 requirement enacted by the Sarbanes-Oxley Act 2002 (US) that auditor’s annually attest to management’s assessment of the reporting company’s internal controls. Although so called non-accelerated filers\(^1\) had not been subject to this requirement, the repeated delays in imposing s 404 on small issuers only fed their appetite for a permanent exemption. Congress granted their request in s 989G of Dodd-Frank.\(^2\) As a result, nearly 6,000 reporting companies representing about 6% of US equity capital and more than half of all the public companies are now outside the internal control attestation requirement.\(^3\) Moreover, the legislation also calls for the US Securities and Exchange Commission (SEC) to study whether firms with a market capitalisation of $75-200 million should also be exempted (s 989B).

Small issuers also received favorable mention in other areas as well. Section 951E of Dodd-Frank authorises the SEC to provide exemptions when it believes regulation would disproportionately burden small issuers. Listing requirements may also relax or eliminate independence requirements for compensation committees (s 952A). More broadly, Dodd-Frank authorises exchanges and Financial Industry Regulatory Authority\(^4\) to exempt categories of issuers, and mandates that they shall take into consideration the impact of their regulations on small issuers (s 952A).

As a generalisation, non-accelerated filers and more broadly yet, small cap companies\(^5\) have more limited product lines, possess fewer financial resources, trade in thin markets,\(^6\) are followed by few, if any analysts, and enjoy a limited following among institutional investors. It is not surprising that the shares for this group of firms are valued inefficiently. Such pricing inefficiency invites harmful

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\(^1\) Broadly defined as reporting issuers, domestic or foreign with a market capitalisation not exceeding $75 million.

\(^2\) See SEC Securities Act Rel No 9142 (15 Sept-2010).


\(^4\) The self-regulatory organisation for broker-dealers.

\(^5\) Most market professionals consider a market capitalisation of less than $1 billion to be small.

\(^6\) Frequently on the non-regulated Over-the Counter Bulletin Board or even “Pink Sheet” markets.
opportunistic behavior by managers. More positively, returns for small cap firms historically are higher, reflecting their need to yield greater financial rewards to investors to compensate for their greater risk.\footnote{See; eg Fidelity Supplement to Small Cap Stock Fund, Fidelity Mid-Ca; Stock Fund and Fidelity Large Cap Stock Fund, 29 June 2005 (reviewing risks and returns of three major categories of indexed funds).}

It is hard to say that the auditors’ attestation per s 404 was without material social benefits. The SEC’s Chief Accountant during the early implementation period of the internal controls requirement observed:

I believe that, of all the recent reforms, the internal controls requirements have the greatest potential to improve the reliability of financial reporting. Our capital markets run on faith and trust that the vast majority of companies present reliable and complete financial data for investment and policy decision-making.\footnote{Nicolaien DT, \textit{Keynote Speech, 11th Annual Midwestern Financial Reporting Symposium, 7 October 2004}.}

For example, studies of accounting restatements consistently track significant increases in the number of accounting restatements following partial implementation of s 404. The restatements peaked in 2006 with 1,564 [888] reporting issuers recording material restatements, and have declined each year since then to reach 630 [374] restatements in 2009 (the numbers in brackets identify the number of non-accelerated filers reporting restatements).\footnote{Audit Analytics, 2009 Financial Restatements: A Nine Year Comparison (February 2010), p 18.} The data reflects the well-documented phenomenon that the number of restatements is inversely related to market capitalisation.\footnote{See Glass Lewis & Co, \textit{The Tide is Turning} (15 January 2008), p 3, Charts 3, 9.} Moreover, nearly 70% of firms reporting material weaknesses in their internal controls that have not remediated weakness had a market capitalisations less than $75 million.\footnote{Glass Lewis & Co, n 10, p 8,Table 2.} Further, in the years 2004 to 2007, the vast percentage of firms receiving a qualified audit opinion on their internal controls were firms with a market capitalisation below $75 million and this group also experienced the highest percentage of auditor changes among all reporting companies.\footnote{Glass Lewis & Co, n 10, pp 9, 13, Tables 4, 13.}

Since there seems little basis to contest the notion that greater accuracy in financial reporting leads to improved pricing of the company’s securities, reduction in the number of restatements should be viewed positively. Moreover, there is evidence that SOX introduced reporting requirements also reduced “financial slack” in complying firms where post-SOX implementation studies report that mandatory filers cut total CEO compensation (most through reductions in stock-based compensation), increased payouts to shareholders, and reduced investment and employment) relative to what occurred with comparable non-404 filers.\footnote{See Qian J, Strahan PE and Zhu J, \textit{The Economic Benefits of the Sarbanes-Oxley Act? Evidence from a Natural Experiment}, Working Paper, December 2009.} Also, mandatory filers post compliance with s 404 experienced longer maturities for their debt than was the experience for non-filers.

But the benefits of improving the quality and trustworthiness of financial reporting came at a significant cost (reporting firms average cost to comply with the internal control requirement was $5.9 million).\footnote{See Charles River Associates, \textit{Sarbanes-Oxley Section 404 Costs and Remediation of Deficiencies: Estimates From A Sample of Fortune 1000 Companies} (April 2005).} And these are costs that are disproportionately more significant for smaller issuers. For example, median audit fees in 2003 and 2004 that implemented internal control reports were 1.14% of reported revenues for non-accelerated filers but 0.13% for firms with a market capitalisation greater than $1 billion.\footnote{GAO, n 3, p 16, Fig 1.} Thus, it was no surprise that while the cost of being a reporting company was identified by 12% of the companies as a reason for deregistering, that percentage jumped to 62% in 2005.\footnote{GAO, n 3, p 22.}
Of special concern for reporting in small companies is that among public companies with a market capitalisation of $125 million or less, the SEC Office of Economic Analysis reports that insiders own an average of 30% of the company’s shares. To the extent one of the goals of financial reporting is to diminish opportunities for opportunistic behavior by managers versus outside owners the smaller firm may well be seen as posing greater risks because of the significant interest held by managers. There has long been concern in small companies that their large block holders can reap rewards at the expense of outside owners through a variety of strategies.

SHAREHOLDER ACCESS

Section 971 of Dodd-Frank authorised the SEC to adopt regulations providing a means for shareholders to nominate directors. The SEC stepped forward with new r 14a-11 permitting shareholders who hold at least 25% of a reporting company’s shares to nominate for election up to three individuals, provided they shareholders have held their shares for three years. Most institutions are gratified that this hard-fought right to participate in the nomination process has been won; most are also surprised by the rather stingy demanding standing requirements that must be met – the three year and 3% conditions – which are more likely to empower the indexed funds as to those issuers large enough to be included in their index who are not the darlings of the most activist oriented investors, the hedge funds.

Because the ownership requirements were not within the legislation, the SEC’s steps must be viewed as certainly cautious to the point of being timid. Despite such a humble provision in the shadow of Congress’s unrestrained authority, a coalition of business groups are now challenging the SEC’s modest shareholder access rule. The bases for the challenge are multiple, including America’s treasured First Amendment protection of speech (the argument here is that it is unconstitutional to require one person, the corporation, to include in its communciation another person’s message) and that the SEC has failed, despite express congressional authority for the rule, to consider the cost and benefits of its modest access proposal.

Most believe the litigation will ultimately be resolved in the Supreme Court. The threat is sufficiently serious to cause the SEC to suspend r 14a-11’s effective date until its validitly is ultimately determined. At the same time, Delaware has once again taken the lead by amending its corporate statute to expressly authorise shareholder-initiated bylaw provisions setting forth procedures for shareholders to nominate directors. Thus in the background of the current challenge to r 14a-11 is the choice between the sweeping mandate of federal government or private ordering via empowerment under the authority of State law.

FUMBLING THE EXTRATERRITORIAL REACH OF THE SECURITIES LAWS

Last June the Supreme Court reached the astonishing conclusion that it was never the intent of the US Congress to proscribe frauds that occurred on foreign markets, even if the conduct underlying the fraud occurred in the US or the fraud produced substantial effects within the US.

As discussed in an earlier note in this column (see “Overseas law: The extra-territorial application of US securities class actions” (2009) 83 ALJ 373), Morrison v National Australian Bank 130 S Ct 2869 (2010), involved Australian investors who purchased shares in an Australian company (NAB) on the Australian Stock Exchange who alleged they had been deceived by false reports prepared by the American subsidiary of NAB. While decisions hostile to investor suits have for the past quarter of a century been something of a sport for a majority of the Supreme Court, the sweeping conclusion of Justice Scalia caught most by surprise.

Despite Morrison being decided near the 11th hour of Dodd-Frank, Congress moved quickly, but not deftly, in addressing the lacunae in the American securities that the sweeping interpretation had created. Section 929Y of Dodd-Frank asked the SEC to study (and report to Congress) whether the securities laws should be amended to provide private suits in US courts for transactions that occur outside the US and also in s 929P, Dodd-Frank amended the securities laws to confer “jurisdiction” for actions by the SEC in the federal courts when “conduct within the United States constitutes significant steps in furtherance of a violation” or for “conduct occurring outside the United States that has a foreseeable substantial effect within the United States”.

212 (2011) 85 ALJ 210
Since Morrison and Dodd-Frank’s enactment, the extraterritorial reach of the US securities laws has become even more important. In February of this year the Deutche Börse and NYSE Euronext announced plans to merge with the ultimate effect that trading in NYSE-listed securities would in fact occur in Frankfurt, not New York. This development is troubling when Congress’ response to Morrison, summarised above, is closely considered. Congress’ fix to Morrison was amending the section of the US securities laws that deal with the SEC’s ability to proceed to a federal court, ie, jurisdiction. Morrison, however, spoke more broadly than whether a federal court or a party before it could invoke the jurisdiction of a federal court for extraterritorial violations. Morrison held that Congress when it enacted the securities laws did not intend their provisions to have any extraterritorial reach (at 2888):

Section 10(b) [the US antifraud provision] reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States.

That is, the Supreme Court ruled, not on jurisdictional grounds, but on substantive grounds, that extraterritorial transactions are outside the securities laws. So understood, notwithstanding Dodd-Frank, the SEC would not have authority to maintain an enforcement action where the trade occurred outside the US. The SEC is currently considering comments it has received in its Dodd-Frank mandated study whether the securities laws should be amended to authorise private suits when trades occur outside the US. The ultimate effects of any recommendation it will make on this subject became even more problematic following the 4 November 2010 election that brought a distinctly anti-regulation group into power in the House of Representatives.

In the meantime, Morrison’s breadth is causing securities suits with any international connection to be dismissed.17

THE UNCERTAIN PATH OF HISTORY

One of President Obama’s advisors famously remarked after the historic election in 2008 that politicians should not waste a good financial crisis. It remains too early to tell whether this is correct. The long-held hostility to private-suits manifested in Morrison exists because the Supreme Court views private suits as unnecessary to deterring misconduct. Congress, in carving out smaller issuers from the internal control attestation requirement, were not persuaded that the costs of more trustworthy financial reporting were worth the costs. And the timid shareholder access provision likely reflects unseas on the part of the SEC in the face of the anti-regulatory sentiment that continues to grip America. Indeed it is the latter that underlies each of these three developments, suggesting that a crisis may well not lead to the type of reforms that introduce more regulation, but rather less. This may reflect no more than the crass political reality that the public mood sees regulation, unlike in the past crises, the cause and not the cure. Thus, the cadmium ring appears nonetheless, but it will be years before we can discern whether it is a ring of growth or decay.

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[Editor’s Note: A column later this year, by Gill North and I, will provide an overview of, and general introduction to, the Dodd Frank Act. – RB]

17 See, eg In re Royal Bank of Scotland Group plc Securities Litigation (unreported, 09 Civ 300), (SDNY 11 January 2011); 2011 WL 167749 (although issuer’s shares were listed on a US exchange the suit was dismissed for failure of plaintiff to allege securities were purchased in the US or in a foreign market); Cornwell v Credit Suisse Group 729 F Supp 2d 620 (SDNY 2010) (dismissing suit by American investors who purchased securities on foreign exchange based on misrepresentations directed to them in the US); Quaal Cruises Ship Mgt Ltd v Agencia de Vagens CVC Tur Limitada 732 F Supp 2d 1345 (SD Fl 2010) (foreign nationals closing private placement of foreign issuer in US does not overcome Morrison).